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**THE IMPACT OF VERTICAL
INTEGRATION ON RETAIL
GASOLINE PRICES IN RUSSIA**

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Abstract: The paper explores factors influencing retail prices in Russian domestic gasoline market in Russia. The role of dominant vertically integrated oil companies is considered to be of great importance, so the author tries to define possible scenarios of development of retail markets of gasoline under existing market structure. Conditions for establishment of retail prices, which tend to be close to competitive ones are discussed.

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Introduction

Modern economic regulation is premised on the benefits of competition. However, the need for competition in the oil industry is not always evident due to several reasons. Except technological factors and transaction costs, causing the efficiency of large vertically integrated oil companies, one of the arguments in support of their existence can be based on the results of economic analysis of market structure. To provide this type of analysis, the development of industrial markets should be considered from the perspective of nonlinear modification of "structure-conduct-performance" paradigm presented by Chicago School of Economics (Sokolova, 2012). The main idea is that market structure itself is less important than the results of the conduct of main market participants – such as production efficiency (as the ratio of input and output), and prices.

For this paper we assume that the price is the key indicator of the efficiency of firms' conduct in the oil industry. Gasoline (petrol and diesel) sold in the domestic retail market is considered to be the final product of the oil industry. Here we do not take into account international prices for crude oil and petroleum products, as they are formed under international competition and, therefore, do not reflect the state of competition in the Russian oil industry.

Thus, the aim of this work is to evaluate the possibility of establishing a competitive gasoline prices in the domestic market in the Russian Federation under high degree of vertical integration.

Development of the oil industry in Russia

Oil industry in Russia traditionally has low level of competition in all stages of production - extracting, transportation and refining. Since the beginning of oil production in the late 19th century in Russia, vertically integrated companies has occupied all stages of the production process in the industry.

The geological structure of hydrocarbon reserves on the territory of our country became one of the main reasons for the high level of market concentration in the Russian oil industry. The Russian oil industry started to develop in Baku by discovery of large oil fields. The first wells of the Baku fields, discovered in 1871 and 1873, opened access to the most important oil fields in the Caucasus. All Russian oil market was served by vertically integrated concern "The Nobel Brothers" - the company owned "wells, pipelines, refineries, tankers, barges, storage, private railway, retail sales network and (...) labor force" (Ergin 2011, p. 68). Despite the existence of small businesses in oil extraction and refinery in Baku, the entire oil industry was controlled by vertically integrated monopoly owned by Nobels. It should be noted, however, that the development of the industry was supported by indirect state regulation of prices - the Russian Empire supported the establishment of tariffs, which increased the competitiveness of Russian oil products compared to imported world leader's kerosene, produced by Standard Oil (Grace, 2005, p. 7).

In 1918, the oil industry was nationalized, but the policy of the NEP, which was announced in 1921 by the Soviet government, has attracted foreign capital and new technologies into the industry. However, until the collapse of the Soviet Union, vertically integrated oil industry remained to be state owned.

Industry reform, which was announced in 1992 after the collapse of the Soviet Union, on the one hand led to the creation of several large, vertically integrated oil companies (VIOCs), on the other hand - to preservation of state control. This was possible due to the transfer of large blocks of shares of privatized VIOCs under the control of the state owned company "Rosneft", as well as the preservation of state ownership of the transportation capacity through the establishment of state pipeline companies "Transneft" and

"Transnefteprodukt." The need for the creation and development of vertically integrated companies in the 90s can be explained by the lack of legitimate mechanisms that reduce the risk of per se opportunism in dealing with independent contractors (Adachi, 2010, p. 38). In this situation, vertical integration significantly reduces the owners' risks. Further development of the oil industry is characterized with increasing role of state controlled VIOCs.

Thus, the Russian oil industry has always had high level of vertical integration, as well as the significant role of the state. Taking into account the importance of path dependency, this paper does not address the possible methods and consequences of forced rejection from vertical integration in oil companies. More attention is paid to the possibility to obtain competitive results of the industry development – the formation of the domestic market prices of petroleum products, which reflect of supply and demand peculiarities, rather than dominant firms' interests.

The state of competition in the oil industry in the Russian Federation

The international community often considers the Russian oil industry as an analogue of the OPEC cartel in the seventies of the twentieth century (Grace, 2005, p. 218). This is explained by comparable to OPEC amount of oil production and export, as well as the role of national government in determining industry development strategy. But if OPEC is an officially declared cartel, the Russian oil industry has 11 formally independent vertically integrated oil companies (VIOCs).

The level of competition in Russian oil industry is extremely low. In 2013, for instance, 180 independent from the VIOCs oil companies extracted only 14.4% of amount of crude oil, extracted by VIOCs, and only 12.59% of the total amount of crude oil in Russia. Thus, even if the competition is possible, then it will be oligopolistic competition of barometric type with VIOCs leadership. Independent oil companies tend to become followers, accepting the rules of the game, set by collectively dominating VIOCs. Moreover, we can assume that, as price competition in the oil market does not exist, and the volume of production of the oil company affects not only its position within the country, but the position in the world oil markets, the results of competition will correspond Stackelberg model of oligopolistic competition for the case of the arbitrary determination of the volume of production – the first mover advantage model.

So, despite those changes in the Russian oil industry, which led to serious redistribution of property rights ("YUKOS" bankruptcy, "NK" Rosneft's" acquisition of TNK-BP, and the redistribution of "Bashneft" shares), the situation in the market after the introduction of foreign sanctions against the industry looks like situation described in the Stackelberg model. The oil company, which was the first to establish production volumes (in our case –started oil extraction, requiring the use of advanced technologies), is likely to remain an industry leader for a long time. Thus, further analysis is carried out on the assumption of stable positions of main players in the domestic market. This assumption facilitates the formation of long-term scenarios for the industry. Existing balance of market forces can only be broken by the intervention of the state.

The analysis of competition in the oil industry in Russian Federation should be carried out by taking into account the level of market concentration at different stages of the production process. A simplified scheme of the oil industry production processes consists of five main stages (except for exploration and transportation), which are characterized by varying degrees of market concentration (see. Table 1).

Table 1.

Competition in industrial markets in oil industry in 2013

The stage of production process	Market share of VIOCs	Market share of independent companies
Crude oil extraction	87,41% ^[1]	12,59% ^[1]
Primary refining	85,6% ^[1]	14,4% ^[1]
Petroleum production (*)	95,53% ^[1]	4,47% ^[1]
Wholesale supply of gasoline to the domestic market	92,38% ^[3]	7,62% ^[3]
Gasoline retailing	45-40% ^[2]	55-60% ^[2]

Sources:

[1] Нефтяной комплекс, Министерство энергетики РФ, <https://minenergo.gov.ru/activity/oilgas/>

[2] Подобедова Л., Галактионова А., Дзядко Т. Нефтяники впервые пошли на уступки независимым операторам АЗС / rbc.ru

[3] Махонин Д.Н. Антимонопольное регулирование и контроль на рынках нефти и нефтепродуктов / http://fas.gov.ru/analytical-materials/analytical-materials_31094.html

(*) here we provide data only on gasoline, assuming it to be the most demanded petroleum product in retail market.

There are three nationwide leaders of crude oil extraction – "NK"Rosneft", "LUKOIL" and "Surgutneftegaz", which provide 65.1% of Russia's crude oil.¹ At regional level, oil production is usually carried out by several companies and in some regions it is almost monopolized. However, the orientation of the mining regions to the export of raw materials leads to the following: their demand for crude oil for domestic needs is met by supply from other regions. In this regard, the Federal Antimonopoly Service (FAS) proposes to consider the geographical boundaries of the crude oil market as the statewide. One of the arguments of appropriateness of this approach to the analysis of the crude oil market in Russia is just a high level of concentration of oil extracting companies in regions. For example, in the case of having to purchase crude oil from the dominant VIOCs, buyers are often face so high prices at nearby fields that the purchase of raw materials in remote areas occurs to be more profitable, even taking into account transportation costs.

Refining, both primary and the production of motor fuel, is done by 68 specialized enterprises, 26 of which (refining 85.6% of crude oil and producing 95.53% of gasoline) are owned by VIOCs. About 88.6% of the gasoline produced is sold in the domestic market (see. Table 1). Thus, the VIOCs are interested in the domestic market of gasoline. In 2013, the wholesale gasoline market in Russia was collectively dominated by four VIOCs – "LUKOIL", "NK"Rosneft", "Gazprom Neft", "Bashneft"(Makhonin, 2014).

Gasoline retailing is the most competitive stage of the production process – 55-60% of the market is served by independent retailers, selling about 33% of the fuel in the retail market (Podobedova, Galaktionova, Dzyadko, 2014). However, due to the lack of independent gasoline wholesalers (see Table 1), the retailers' dependence on VIOCs is tends to be significant. The situation in retail gasoline market in Russia is not unique – there are examples of various forms of interaction of players in the world – starting from complete vertical integration till completely independent retailers (OECD, 2010). It is possible to find either vertical integration or vertical restraints between refineries and gasoline retailers.

Depending on a number of additional factors, a high level of vertical integration, combined with a high level of market concentration, can have either positive or negative effects on the performance in the of end-markets (gasoline markets). Existence of a large number of independent gasoline retailers makes it possible to talk about the ambiguous

¹ Нефтяной комплекс, Министерство энергетики РФ, <https://minenergo.gov.ru/activity/oilgas/>

outcome of market interaction in terms of pricing for consumers. The market can introduce either competitive prices due to the high proportion of independent gas stations or monopolistically high prices, due to the existence of dominant vertically integrated oil companies.

The role of vertical integration in the competitive performance of the oil industry

Competition in the industrial markets is determined not only by the level of concentration and entry barriers. The great impact has competition in the adjacent stages of the production process. So, even if the market is competitive, the high level of market concentration at other stages of the production cycle can neutralize the potential benefits of competition. The most probable consequences of such a situation are vertical integration, or vertical restraints.

In theory, the effects of vertical restrictive contracts and vertical integration are considered to be different. Thus, the benefits of vertical integration are the reduction of transaction costs of the interaction between the producers at different stages of the production process, technology driven cost reduction and the absence of double monopolistic markup. The main negative effect of vertical integration is elimination of competition at all stages of the production process, including the markets in which independent from the vertically integrated firm players still remain. In some cases, the appearance of a vertically integrated monopoly may lead to cartel agreements between it and independent players (Viscusi et. Al., 2000, p. 228). But it is likely to happen only in case where the concentration among independent players is also high.

At the same time it is obvious that non-integrated players' decisions depend on decisions of vertically integrated company. First of all, we are talking about vertical restraints between vertically integrated monopoly and its competitors in one of the markets served.

Vertical restricting contracts are similar to vertical integration in the short term. However, the opportunistic behavior is more likely to occur in this case due to the lack of incentives of non-integrated players to follow the terms of these contracts. From the point of view of competition, the threat of opportunism becomes one of the advantages of such quasiintegration as it restrains the abuse of dominance by dominant companies in respect of independent contractors.

Vertical contracts relate to various restrictions imposed by the dominant firm. Vertical restraints, as well as vertical integration, reduce the transaction costs of market exchange for both parties of the agreement, which may have a positive effect on the level of prices of final goods. However, in a situation where one of the parties to the contract has significantly greater market power than the other, different types of abuse of dominance appear in the market.

In summary, the vertical restraints can be divided into two groups: resale price maintenance and the exclusivity conditions. The resale price maintenance relates to either high or low prices for final consumers. Exclusivity conditions relate to limitation of geographical markets, suppliers and so on. These restrictions take many forms and are often combined to each other.

In both cases – in the case of vertical integration, and in the case of vertical restraints – the actual level of market concentration is close to monopoly. And in the case of monopoly, even in the absence of a double monopoly markup, prices may become significantly higher than competitive one. And this is the most likely outcome in the case of a complete lack of competition at any stage of the production process.

International experience shows that there are different types of state intervention in the industries with high level of vertical integration – starting from the regulation of the

geographical distribution of gasoline retailers in the market till state regulation of retail gasoline prices. Direct state regulation of retail prices and market entry and forced separation of vertically integrated companies in the oil industry is rarely used now (OECD, 2010, p. 94). Despite the negative effects of vertical integration, state intervention in these market relations does not always lead to improvements in the market. The most drastic measures involving the forced separation of vertically integrated companies, usually cause a rise in prices in the retail market (OECD, 2010, p. 96). This can occur either as a result of the introduction of double monopoly markup or as a result of the implementation of the market power of retailers in the local geographic market.

The negative effects of vertical integration in the oil industry in many countries are still mitigated due to competition in the retail market of gasoline. In this case, the effective confrontation with vertically integrated monopolies ensured not by independent retailers of gasoline, but by the largest outlets entering the market of gasoline and offering customers gasoline at their own gas stations. These new competitors can withstand predatory gasoline prices, set by oil majors. On the other hand, the emergence of such new market makes the oil majors and independent retailers of gasoline to offer a wider range of goods and services in their own gas station stores, which strengthens their position in the non-core markets. These changes in the retail competition lead to a shift in emphasis from competitive retail market to wholesale market of gasoline. Thus, regulation of the domestic retail market of gasoline should be based primarily on the study of the interactions of the vertically integrated wholesale market vendors and independent sellers in retail market.

The impact of vertical integration on competition in Russian oil industry

The interest of the Russian oil majors in the integration of independent gasoline retailers depends on their control over pricing and corresponding benefits.

Currently, retail prices of petroleum products in Russia are not regulated directly by the state, but the Federal Antimonopoly Service (FAS) monitors them. After implementation of these measures, there a number of antitrust cases were initiated. Dominant vertically integrated oil companies were accused in setting monopolistically high prices and pushing competitors out of the market of petroleum products, which also led to an increase in gasoline prices.

FAS charge cannot be considered as unambiguous due to the peculiarities of the market structure in the petroleum industry. Thus, the prosecution of VIOCs in establishing monopolistically low prices cannot be sustained due to the fact that large manufacturers are generally more efficient than their smaller competitors. In this case, low prices just reflect the average costs of vertically integrated oil companies, but not their desire to oust competitors from the market. In turn, the high prices can be mounted in two cases. First, it is the dominance of independent retailers in the local market, which leads to the establishment of a double markup, and in this case the role of vertically integrated oil companies in the overpricing is not obvious. Second, it is restricting vertical agreements with independent gas station, which fix the minimum price of gasoline in the domestic market — here the position of the prosecution is more obvious.

When analyzing the possible effects of vertical integration in the petroleum industry, it is necessary to give an answer to three questions: (1) whether the price of gasoline is really overpriced, (2) whether it is possible to reduce prices by refusing from vertical integration and (3) whether reduction in gasoline prices in the domestic market is possible through the intervention of government regulators. Further we provide arguments in support of the answers to these questions.

Gasoline prices in the domestic retail market in Russia

Since the cost of a liter of gasoline in the domestic market in Russia for more than half (51.24% prior to 1 January 2015, 55.79% - after 1 January 2015) is the sum of the export price of gasoline less fees, it should be understood that export wholesalers of oil (oil majors) play a significant role in the formation of pricing policy. In this case, the price of crude oil and petroleum products for the domestic market is established by mining company regardless the factor of demand for this raw material – in the first place there is the problem of downloading their own facilities and the wholesale price for petroleum products.

It is believed that in the face of declining world oil prices vertically integrated companies should have incentives for cross-subsiding by raising prices for petroleum products in the domestic market. However, this thesis can be called in question for two reasons. First, in January 2015 the new rules of the taxation of the oil industry were implemented. These rules significantly reduced profitability of sales of crude oil and petroleum products in the domestic market as compared to the export operations. Secondly, the study of the structure gasoline prices (see. Table 2) shows that having high share of taxes (65%), even a slight increase in gasoline prices in the retail market should be connected (having the other factors constant) with considerable price manipulations held by wholesalers and retailers.

Table 2.

Gasoline price structure in USA and Russia

Element of the price	The share of the element in USA	The share of the element in Russia
Crude oil	64%	7%
Refining services	14%	10%
Taxes	12%	65%
Transportation and sales	10%	18%

Sources: <http://www.rfu.ru/images/docs/analitika.pdf>

Since even before the changes in taxation (in 2014) there were different rates of increase in prices for gasoline AI-92 in different regions, it can be assumed that these changes were connected to the pricing policy of wholesalers or retailers. Thus, the highest growth rate in end of November compared to the end of January (22.31%) were in Tuva, and the lowest for the same period of time – in Chukotka (4.06%) and Kamchatka (1.51%). Increase in AI-92 gasoline prices for more than 20% was observed in 8 regions (including Tuva). The increase in prices below the inflation rates (11.36% according to Goskomstat) was in 35 regions.

Despite significant rate of increase in prices for gasoline, it is impossible to say unambiguously whether the price of gasoline at the retail market corresponds competitive level or not. Intracorporative sales of hydrocarbons carried out by VIOCs, do not give regulators the possibility to obtain reliable data on the cost of gasoline, complying with the market needs. Therefore, further conclusions of this work are based on the assumption of necessity to reduce the information asymmetry between the refineries, gasoline wholesalers, and retailers.

Making gasoline prices to be closer to a competitive level while having vertical integration in the market

Whether the prices are set close to the competitive level or not depends on the relationship between independent retailers of gasoline and oil majors. Until recently, there were no uniform rules for the formation of prices in contracts between the vertically integrated oil companies and independent gas stations. This gave VIOCs additional incentives to impose vertical restraints on retailers.

In December 2014 the Ministry of Energy discussed possible changes in the conditions of the supply of fuel from the oil majors to the independent gasoline retailers. The changes discussed included following methods for determining the price (Podobedov, Galaktionova, Dzyadko, 2014):

1. On the basis of the average stock exchange price for the St. Petersburg International Mercantile Exchange (SPIMEX) for the period of five working days, taking into account the cost of transportation and storage of gasoline, plus fixed margin for small wholesalers.
2. On the basis of the selling price of the refinery for the delivery date, based on the same cost as in the first case, except that the margin should be revised twice a week.
3. On the basis of average prices of fuel at gas stations, belonging to the wholesaler in this region minus differential (fixed in rubles per ton).

Independent gas stations are offered to sign up long-term contracts either on the basis of 100% prepayment, or with deferred payment. However, in the latter case independent buyers of motor fuel should take on commitments to purchase fixed volume – "take-or-pay" contracts. We can see that these terms and conditions of contracts for the supply of petroleum products reflect the dominance of vertically integrated oil companies in their relations with independent gas stations.

In the second and third pricing options the price entirely depends on the decision of VIOCs. In the first case there is the possibility that the level of the retail price will be influenced by market supply and demand factors to a greater extent. So further we are going to discuss exchange prices for gasoline.

At the end of March 2015 "NK"Rosneft" and FAS have agreed on standards regulating the pricing principles and procedures for domestic gasoline market. According to the document, "NK"Rosneft" promises to sell motor fuel to all contractors in the domestic market, including subsidiaries and associates, at a single wholesale price calculated on the basis of exchange prices, and export prices. Also it was promised to have non-discriminatory pricing for all market participants².

This method of setting retail prices, taken by the market leader, on the one hand, becomes a major step towards the formation of transparent pricing policy – the leading position of "NK"Rosneft" will make other oil majors to join the new pricing rules. On the other hand, the same leading position of "NK"Rosneft" may jeopardize the integrity of the behavior of participants in exchange trading, which became mandatory in the Russian Federation a little time ago.

The decision on mandatory sales of VIOCs' oil and petroleum products on commodity exchanges was adopted by FAS and the Ministry of Energy of the Russian Federation in 2013. It was assumed that regular exchange trading should lead to the formation of an information base for the calculation of price indices for oil and petroleum products in the domestic market. Exchange trading should be based on the balance of supply and demand, rather than on the oil price in the world markets. Thus, according to the draft of federal law "On the market pricing of oil and petroleum products in the Russian Federation", the price of oil and petroleum products in the domestic wholesale market should be determined on the basis of three price indices: price index of comparable markets, price index of non-exchange transaction transactions and index of exchange transactions. The primary purpose was to determine the price indices for prices at which oil and petroleum products should be purchased in the domestic market, mostly – by public organizations and public authorities.

² «Роснефть» и ФАС согласовали принципы ценообразования и порядок реализации продуктов в РФ// Источник: http://fas.gov.ru/fas-news/fas-news_36382.html. Дата обращения: 16.04.2015.

And prices for public procurement, in turn, will have an impact on retail prices for final consumers.

Despite the seeming obviousness of this new pricing mechanism, exchange trading for oil and petroleum products in Russia has a number of limitations.

Firstly, the high degree of vertical integration in the petroleum industry leads to the great amount of non-exchange sales – up to 85% of contracts. They include intra-corporate sales, and long-term contracts for the sale of excessive crude oil to independent refineries. So, since the amount of mandatory sales of petroleum products, established by the law №313/13/225, does not exceed 10% of the total monthly volume of production, then, in case of increase in prices in this segment of the market, VIOCs can lower prices of non-exchange transactions without control and significant damage to themselves. This, in turn, increases the competitiveness of their subsidiaries and, therefore, may lead to an increase in market concentration in related markets due to the growth of the subsidiaries' sales, as well as due to the acquisition of small independent competitors. In case if exchange prices occur to be lower than the official world oil prices, it also affects competing independent companies, but those who work in the earlier stages of the production process – at the stage of extracting or refining, and participate in exchange as a seller.

Thus, the relative insignificance of the sales' volume for the oil majors, which becomes significant in comparison with the sales volumes of independent companies, create for VIOCs an incentive to manipulate prices. At the same time VIOCs are able to compensate resulting losses by in the competitive behavior in different stages of production processes. Similar problems (but significantly enhanced by technological features of gas transportation) emerged in Russia during the period of gas trading on the electronic trading platform (ETP) from 2006 to 2008 (Sokolova, 2014). Free gas trading was dominated by a single vendor – "Gazprom", whose sales volume, according to the regulatory rules, had to be equal to the aggregate sales volume of independent (from "Gazprom") gas sellers.

Furthermore, the relatively small volume of stock sales of oil can lead to the situation, when price increases depend not on the characteristics of demand, but on the "holding" of resources during periods of demand peak in order to sell them at higher prices later (Trebling, 2008 p. 470). At the present time, in the face of shrinking supply of gasoline from Belarus, the oil companies are already increasing their own gasoline reserves, while maintaining fuel supply shortages in the domestic market.³

Second, selling goods in a market with highly concentrated sellers leads to probability of collusion between the exchange traders. It possible to avoid collusion while selling oil and petroleum products on the exchange, but it is difficult to do. In case of exchange trade it is possible to avoid collusion only if the participants do not have any information that allows them to identify seller and/or buyer, i.e. they should not know the cost of transportation of the fuel to its destination (Zapadayev, 2010, p. 7). In particular, if this information is available than it is simple do define refinery, which acts as a seller of the product – a limited number of market participants and a limited number of trading platforms make it possible to overcome the anonymity.

In practice, the mandatory exchange trading of oil and petroleum products in Russia led to ambiguous, in terms of the competition, results. On the one hand, the aim of obtaining information on the market prices of oil and petroleum products was formally achieved. On the other hand, according to the Russian Fuel Union, there were manipulations of wholesale prices on the exchange, held by VOICs. VIOCs were buying gasoline from each other on the exchange and the same time reduced sales volumes of gasoline on the exchange. It led to an

³Дмитрий Махонин о самом актуальном на рынке бензинов / Источник: http://fas.gov.ru/fas-news/fas-news_36446.html Дата доступа: 15.04.2015.

increase of stock prices till the level of export parity. This became possible because the domestic market is not a priority for producers of petroleum products.

Conclusion

Thus, it appears that the existence of independent gas stations in case of incomplete vertical integration of VIOCs creates for them incentives and conditions to abuse their dominant position. The purpose of possible abuse is to push small gas stations out of the market (through predatory pricing at VIOCs's gas stations) or via increase of wholesale prices for gasoline to prevent competition from independent gas stations. The result of these practices is gasoline price increase in domestic retail market.

Given the high degree of vertical integration in the industry, the existence of prices, which are close to the competitive level, can only be provided by increase of market power of independent retailers of gasoline. This requires execution of one of two conditions:

- ensuring a high degree of concentration of independent gas stations in separated geographical markets;
- providing access to the retail market for non-core vertically integrated companies.

Introduction of relatively large independent players in the retail market will reduce the amount of manipulation with the wholesale price of petroleum products not only by strengthening the role of the buyer, but also through the improvements in exchange of information on the wholesale price of gasoline between independent gas stations.

The existing structure of the retail market of gasoline makes it impossible to set prices close to competitive, even by implementation of quasi-competitive pricing policies.

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